

CHAPTER 1**Professional Practice****LEARNING OBJECTIVES**

	Review Checkpoints	Exercises and Problems
1. Explain why <u>auditing</u> is useful.	1, 2, 3, 4	EP 1,2,6
2. Distinguish <u>auditing</u> from <u>accounting</u> .	5, 6	EP 4
3. Define and explain auditing, especially its role in information risk reduction.	7	EP 3, 8
4. Describe the current environment of auditing, including regulatory oversight	8, 9	EP 9
5. Describe the other major types of auditing and auditors.	10, 11, 12, 13,14, 15, 16, 17, 18, 19	EP 5,7
6. Describe the organization of public accounting firms, and identify the various services they offer.		
7. Provide an overview of international auditing	20, 21	
8. List of websites for professional accounting organizations (Appendix 1A)		
9. Chronicle the historical development of auditing standards, including the criticisms of the profession and its responses (Appendix 1B).		
10. Describe the alternative theories of the role of auditing in society (Appendix 1C).		

POWERPOINT SLIDES

PowerPoint slides are included on this site. Please take special note of:

- * Overview of Financial Statement Auditing
- * Objectives of Audit

SOLUTIONS FOR REVIEW CHECKPOINTS

1.1 Auditors add credibility to financial information provided by the accountable party such as management (i.e. auditors make the financial or other information more likely to be true). Other common ways of characterizing this property of audited numbers is that the numbers are more accurate, have higher assurance, or are more reliable. These relate to different dimension of truthfulness, as we discuss later in the text.

1.2 Auditing is the verification of numbers provided by others. To attest means to lend credibility or to vouch for the truth or accuracy of the statements that one party makes to another. The attest function is a term often applied to the activities of independent PAs when acting as auditors of financial statements.

Since financial statements are prepared by managers of an entity who have authority and responsibility for financial success or failure, an outsider may be skeptical that the statements are objective, free from bias, fully informative, and free from material error--intentional or inadvertent. The audit opinion of an independent-PA auditor helps resolve those doubts because the auditor's success depends upon his independent, objective, and competent assessment of the conformity of the financial statements with GAAP. The auditor's role is to lend credibility to the statements, hence the outsider will likely seek his independent audit opinion.

1.3 Client: the company, board of directors, agency, or some other person or group who retains (hires) the auditor. Usually the party who pays the fee.
 Auditee: the entity (e.g., business firm, hospital, city government) whose financial information is under audit.
 Auditors: report to the client on the auditee's financial or control information.

Three party accountability consists of the auditor, the accountable party of the auditee such as management of the auditee, and the users. Users include the client as defined above. Traditionally management hired the auditor so that there was some confusion as to who was the true client. New corporate governance concepts in part attempt to clarify this three party accountability.

1.4 Auditors performing auditing gather evidence related to the assertions management makes in financial statements and render a report. Accountants performing accounting record, classify, and summarize (report) a company's assets, liabilities, capital, revenue, and expense in financial statements. Accountants produce the financial statements, auditors audit them.

1.5 The conditions of complexity, remoteness and consequences produce demands by outside users for financial reports. They cannot produce the reports for themselves because of these conditions. Company managers and accountant

produce them.

- 1.6 Students can refer to the AAA and CICA definitions in Chapter 1. Some instructors may want to extend the consideration of definitions to include the internal and governmental definitions. In response to "what do auditors do," students can refer to Exhibit 1-2 and respond in terms of: (1) obtain and evaluate evidence about assertions management makes about economic actions and events, (2) ascertains the degree of correspondence between the assertions and GAAP, and (3) gives an audit report (opinion).

Students can also respond more generally in terms of "lending credibility" to financial statements presented by management (attestation).

- 1.7 The essence of the risk reduction theory is that audits of financial statements reduce the information risk (probability of materially misleading statements) to users to a socially acceptable level.
- 1.8 Self-regulation refers to the powers a professional group has in regulating its affairs without intervention by the government or government established external regulator. These affairs include setting of standards, codes of conduct, education requirements, certification, and disciplining of members.

Financial analysts and investors depend upon financial reports for making stock purchase and sale decisions.

Creditors (suppliers, banks, etc.) use them to decide whether to give trade credit and bank loans.

Labor organizations use them to help determine a company's ability to pay wages.

Government agencies and Parliament use them in preparing analyses of the economy and in making laws concerning taxes, subsidies, and the like.

These various users cannot take it upon themselves to determine whether financial reports are reliable, therefore low in the information risk scale. They do not have the expertise, resources, or time to enter thousands of companies to satisfy themselves about the veracity of financial reports. Thus they hire independent auditors to perform the attest function and reduce the information risk.

- 1.9 The Canadian board (CPAB) is more self regulatory in that the profession has more influence through having a higher percentage of board membership, the monitoring process is less public and more designed to help firms improve their practices. The CICA continues to set audit standards. The PCAOB, on the other hand, not only sets standards but also has a more confrontational and public approach in its monitoring process.
- 1.10 Forensic accounting is the broader term that includes fraud auditing. Forensic accounting is the use of accounting for legal or investigative purposes. Fraud auditing is the use of forensic accounting in criminal investigations involving allegations of fraud. Frauds that PAs are most interested in are misappropriation of assets and fraudulent financial reporting (misreporting).
- 1.11 Fraud is intentional deception resulting in injury to another. Frauds that PAs are most interested in are misappropriation of assets and fraudulent financial reporting (misreporting).
- 1.12 Operational auditing is the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies.

The CICA views operational auditing as a type of management advisory service offered by public accounting firms.

- 1.13 The elements of comprehensive auditing include: (1) financial and compliance audits, (2) economy and efficiency audits, and (3) program results or effectiveness audits. Public sector is the part of the economy represented by all levels of government. Public companies are companies whose shares are traded on the stock markets.
- 1.14 A compliance audit involves a study of an organization's policies, procedures, and performance in following laws, rules, and regulations. An example is a company's compliance with environmental laws.
- 1.15 Other kinds of auditors: Revenue Canada agents/auditors, provincial and federal bank examiners, provincial insurance commissioner auditors.
- 1.16 Financial statement audits are intended to provide assurance there are no significant intentional or unintentional misstatements.
- 1.17 CA's, CGA's, and CIA's
- 1.18 Examples of attestation services:
- Vote counts (Academy Awards)
Amount of prizes claimed to have been given in sweepstakes advertisements
Investment performance statistics
Characteristics claimed for computer software programs
- 1.19 Audits of financial statements?
Auditing Standards
Work on unaudited financial statements of public companies?
Review Engagement Standards
Work on unaudited financial statements of public companies?
Compilation Engagement Standards (SAS)
- The three major areas of public accounting services:
Accounting and auditing
Taxation
Management advisory services (consulting)
- 1.20 The SEC site is more comprehensive but covers only Canadian companies cross listed on U.S. exchanges.
- 1.21 The IFAC site is at www.ifac.org and click on "standards and guidance."

SOLUTIONS FOR MULTIPLE CHOICE-QUESTIONS

- MC1 a. Incorrect. This could be correct, were not c. a choice with the more exact word "auditee."
b. Incorrect. Detecting fraud is not the only task in an audit.
c. Correct. Auditors lend credibility to the statements of the entity under audit.
d. Incorrect. A program results audit usually produces a report of findings rather than an attestation to a management report of results.

- MC2 a. Incorrect. Megabank is the user of the financial statements.
 b. Incorrect. S & D is the auditor.
 c. Correct. Company A hired the auditors (and will pay the fee).
 d. Incorrect. Company B is the auditee.
- MC3 a. Correct. The proper reference is to GAAP.
 b. Incorrect. The CICA does not refer only to the FASB for GAAP.
 c. Incorrect. The reference to the Accounting Standards Executive Committee
 is wrong.
 d. Incorrect. This is an abstract of the AAA definition.
- MC4 a. Incorrect. "Complexity" is a good answer, but d. is better.
 b. Incorrect. "Remoteness" is a good answer, but d. is better.
 c. Incorrect. "Consequences" is a good answer, but d. is better.
 d. Correct. Skepticism, or potential conflict of interest, generally
 drives the demand for audited financial statements.
- MC5 a. Correct. Operational audits are defined as MAS practice by the AICPA.
 b. Correct. Internal auditors perform operational audits.
 c. Incorrect. While GAO auditors perform operational audits, they usually

- d. Incorrect. do not do them for "companies" as suggested by the stem. Because c. is not correct.
- MC6 a. Incorrect. Auditors do not reduce or control business risk.
 b. Correct. While "reduce and control" are not well-chosen words, this is the best answer because auditors give some assurance that the information risk is low.
 c. Incorrect. This is taken from the economics of auditing feature of demand for accounting services.
 d. Incorrect. (This is the throwaway!) Audits do not affect quality reviews.
- MC7 a. Incorrect. The primary goal is d.
 b. Incorrect. The primary goal is d.
 c. Incorrect. The primary goal is d.
 d. Correct. Compliance refers to following laws, rules, regulations, and policies.

SOLUTIONS FOR EXERCISES AND PROBLEMS

EP1 When the PA is hired by Hughes Corporation, he can no longer be considered independent with respect to the annual audit. The annual audit may then be unnecessary in a short-run view and unnecessary to the extent of services exclusive of the attest opinion. It is true that the in-house CPA can perform all the procedural analyses that would be required of an independent audit; however, it is extremely unlikely that he could inspire the confidence of users of financial statements outside the company. He cannot modify the perception of potential conflict of interest that creates demand for the independent audit. As a matter of ethics rules, this PA would be prohibited from signing the standard unqualified attest opinion.

EP2 You should point out that you will be unable to replace the independent audit with your own communication output as controller. Make the point that you can conduct an effect internal audit function and be of considerable service to management and can even assist the independent auditors with preparation of schedules and general cooperation (thus facilitating the independent audit).

Nevertheless, as a member of management, it would be impossible to be truly objective and unbiased about the financial results of management's decisions, hence the directors could not satisfy their obligations to the shareholders' interests. Neither could you issue an opinion to be used by outsiders.

Lacking an opinion on the financial statements, the company could find itself in noncompliance with audit requirements of a stock exchange, a Provincial Securities Commission, or the U.S. Securities and Exchange Commission.

- EP3
- a. risk of litigation needs offsetting lower information risk (for example, litigation due to share price decline or failure to meet a bond covenant).
 - b. strength of internal controls (e.g., controls over financial instruments, controls over cash).
 - c. financial health of client (industry factors, economic factors).
 - d. management compensation system (management highly motivated to beat earnings targets, compensation tied to factors over which management has little control may motivate management to "manage earnings").
 - e. private vs. public company (publicly held company owners are more reliant on financial statements for information about their investment).

EP4 Financial statements are prepared on basis of GAAP. Knowledge of GAAP is thus indispensable for determining if the financial statements are in conformity with GAAP. For example lease accounting consists of some very specific rules (bright line rules) that the auditor effectively tests compliance with. Unfortunately such detailed rule based accounting leads to what some refer to as a checklist mentality where the form is more important than the substance. Enron's special purpose entity accounting also comes to mind.

EP5 Operational Auditing

Bigdeal cannot hire the OAG. This government agency does not perform operational audits for private industry.

One possibility is the management advisory services department of a large PA firm. The major advantage may be total objectivity. The PA firm has no stake in making a report reflect favorably or unfavorably on Smalltek (provided there are no prior relations of the PA firm with Bigdeal managers that may suggest a bias or with Smalltek). The possible disadvantage is that the PA firm may not possess the required expertise in Smalltek' type of business.

Another possibility is the Bigdeal internal audit department. The major advantage may be a thorough appreciation of Bigdeal's managerial effectiveness and efficiency standards and a longstanding familiarity with Bigdeal's business. The possible disadvantage could be that the internal auditors may not be independent enough from internal management pressures for making or breaking the deal for reasons other than Smalltek's efficiency and effectiveness.

Another possibility is a nonPA management consulting firm. The major advantage of objectivity would be similar to the PA firm, and such firms often have experts in manufacturing, sales, and research and development management. The major disadvantage could be a lack of appreciation and familiarity with Bigdeal's management standards (as possessed by the Bigdeal internal auditors).

EP6 The neighbor appears to be uninformed on the following points:

1. According to auditors' dogma, Price Inform your neighbor that Dodge

Waterhouse did not prepare the Dodge Corporation financial statements, and no auditor prepares a company's statements.

management is primarily responsible for preparing the financial statements and deciding upon the appropriate accounting principles.

2. An unqualified opinion does not mean an investment is safe.

Tell your neighbor that the financial statements are history. The value of his investment depends on future events, including the many factors that affect market prices. Tell him the opinion only means that the statements conform to GAAP (and you can add that the auditor knows of no material fraud or error).

EP7 Identification of Audits and Auditors

The responses to this matching type of question are ambiguous. The engagement examples are real examples of external, internal and governmental audit situations. You might point out to students that the distinctions among compliance, economy and efficiency and program results audits are not always clear. The "solution" is shown below in matrix form, showing some engagement numbers in two or three cells. The required schedule follows.

Type of Audit

Kind of Auditor	Financial Statement	Compliance	Economy, Efficiency	Program Results
Independent PA	2, 10			
Internal Auditor		6, 8	4, 8	
Governmental (AGC)		3	1, 3, 9	1, 3
Revenue Canada				
Auditor	X	5	X	X
Bank Examiner	X	7	X	X
1. FHA loan interest equity		Economy and Efficiency or Program Results		Governmental (AGC)
2. Advertising agency financial statements		Financial statement		Independent CPAs
3. Dept. of Interior policies		Compliance or Economy and Efficiency or Program Results		Governmental (AGC)
4. Municipal services		Economy and Efficiency		Internal auditors
5. Tax shelters		Compliance		Revenue Canada

			auditors
6.	Test pilot reporting	Compliance	Internal auditors
7.	Bank solvency	Compliance	Bank examiners
8.	Materials inspection by manufacturer	Compliance or Economy and Efficiency	Internal auditors
9.	Drug enforcement vehicle seizures	Economy and Efficiency	Governmental (AGC)
10.	Sports complex forecast	Financial statement	Independent PAs

EP8 Analysis and Judgment

This problem is one of Robert Ashton's cases on judgment and decision making (Accounting Review, January, 1984, pp. 78-97.) Ashton gives credit to Joyce and Biddle, "Anchoring and Adjustment in Probabilistic Inference in Auditing." Journal of Accounting Research, Spring, 1981, pp. 1